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In Ed Gallucci's cover photograph, a question mark replaces the second "S" in U.S. Steel's famous logo, rendered for FORTUNE by Nicholas Fasciano. A story on the Pittsburgh behemoth's new emphasis on its non-steel businesses begins on page 28.

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FORTUNE

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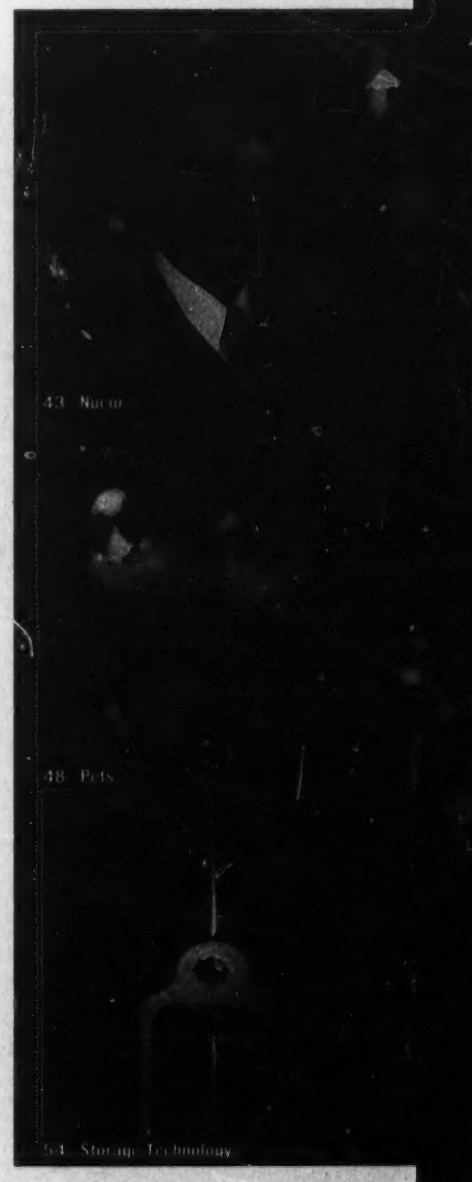

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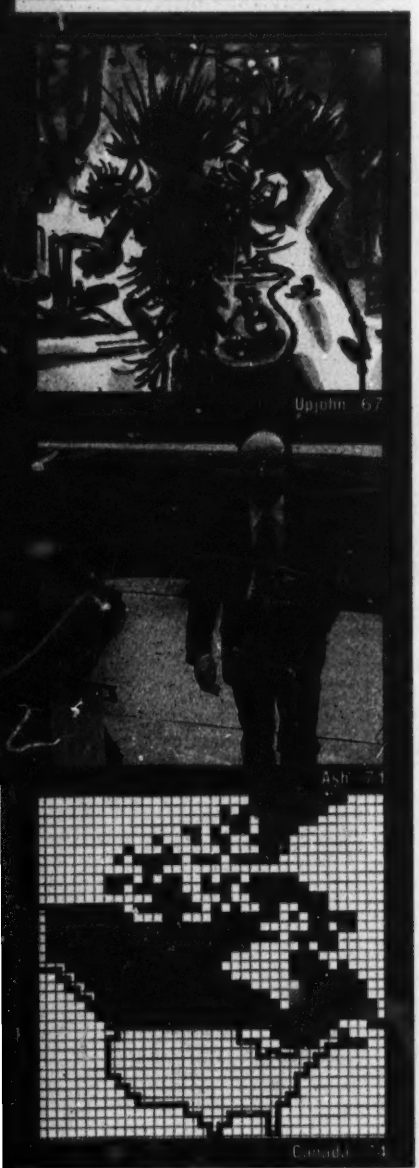

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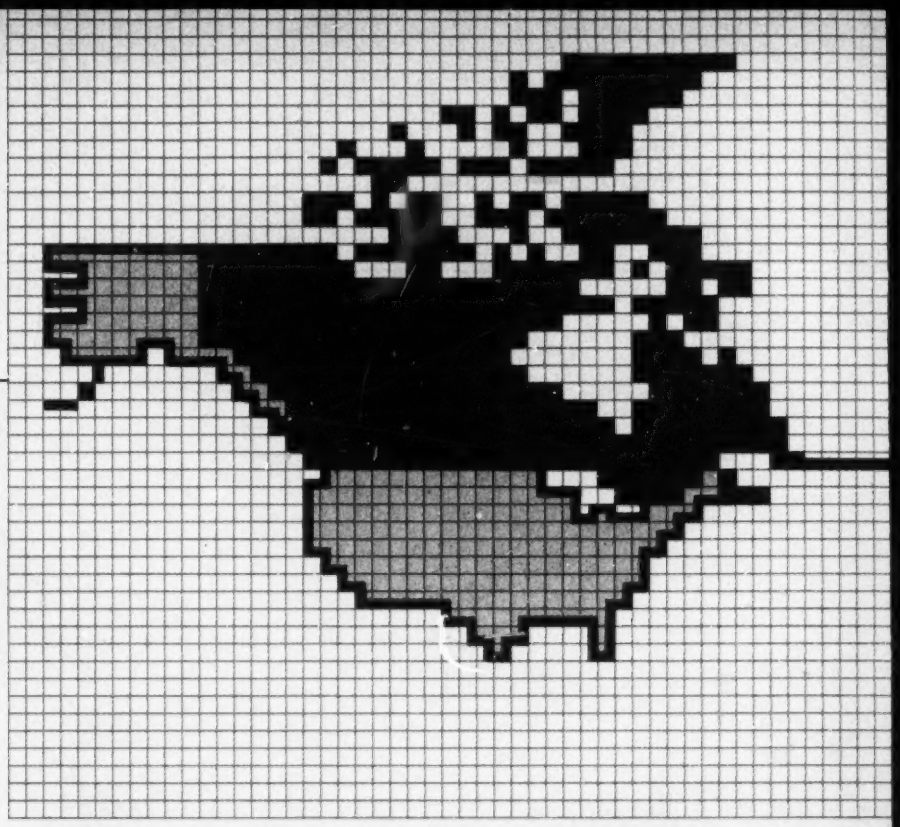


The investment climate for foreign companies in Canada, already frigid in the energy industry, is now getting chilly across the board.

Trudeau's War

by HERBERT E. MEYER

President Reagan's visit to Ottawa last week served to remind us that the U.S. and Canada disagree about quite a lot these days. The news from Ottawa suggested, however, that one extremely sensitive subject—the future of U.S.-owned companies in Canada—was scarcely touched upon. In the long run, that subject is apt to prove more divisive than the widely publicized disagreements about El Salvador, acid rain, and fishing rights.

The heart of the matter is the course of economic nationalism on which Pierre Trudeau, Canada's mercurial Prime Minister, is again embarked. U.S.-owned energy companies have already come under attack by Ottawa, in the form of an energy program designed to reduce foreign ownership of this industry from 70% to 50%. But it seems increasingly probable that Trudeau's policies will force out U.S. companies in many other industries.

Among the measures contemplated:

■ Continued use of Petro-Canada, the government-owned oil company, to buy up foreign-owned energy companies. In February Petro-Can agreed to pay $1.2 billion for the Canadian subsidiary of Belgium's Petrofina.

■ Expanded use of Canada Development Corporation (CDC), which is 49% government-owned, to buy foreign-owned companies in non-energy fields.

■ Expanded use of the Foreign Investment Review Act (FIRA). For example, the Foreign Investment Review Agency, which enforces the act, may begin conducting "performance evaluations" of foreign-owned companies to determine whether they are good corporate citizens; companies that flunk will be invited to mend their ways or sell out.

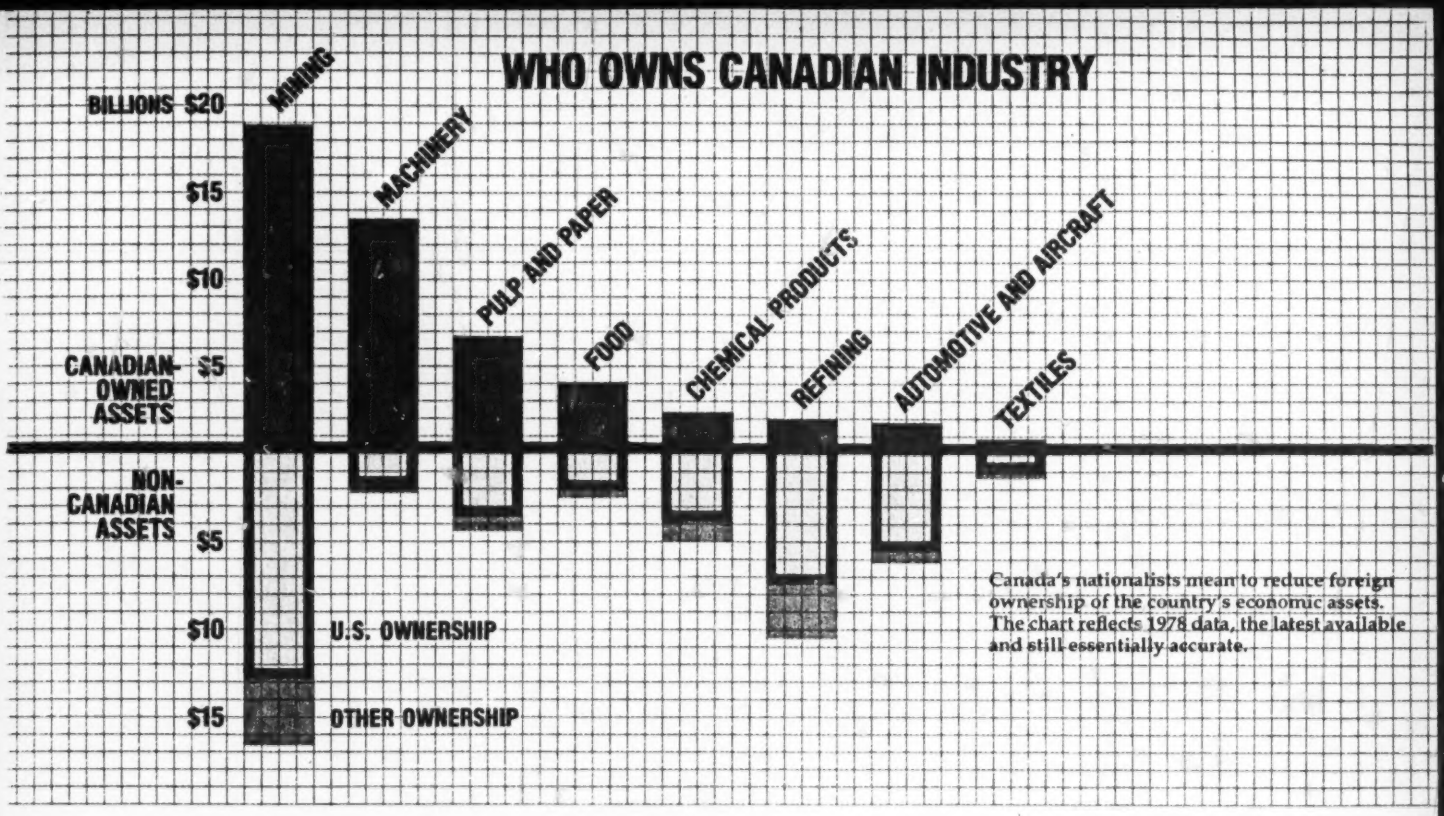
■ Rigid enforcement, and possible expansion, of the so-called Gillespie Guidelines. Named after the cabinet minister who formulated them in 1975—and virtually ignored by Ottawa up to now—these 14 "Principles of International Business Conduct" outline a code of behavior that foreign-owned companies should follow if they wish to be viewed as good corporate citizens. Among other things, the guidelines urge foreign-owned companies to conduct R&D in Canada and to secure from their home offices "world mandates"—assignments to be sole suppliers of certain products, with authority to export from Canada.

■ Expansion of the Enterprise Development Program to help Canadian companies purchase foreign-owned assets in Canada, by guaranteeing private loans made for this purpose.

Research associate: Anna Cifelli

Better than Iran

In a recent interview with FORTUNE, the government official most concerned with these measures professed to see no reason why U.S. and other foreign executives should be troubled by them. "Canada will remain an attractive place to do business," insisted Herb Gray, Minister of Industry, Trade, and Commerce. Clearly, the minister shares a feeling, widely held among Ottawa bureaucrats, that for too long foreign investors have been enjoying a free ride—that the investment climate for foreign-owned companies has been so congenial that Ottawa can lower the temperature by quite a few degrees without



Canada's nationalists mean to reduce foreign ownership of the country's economic assets. The chart reflects 1978 data, the latest available and still essentially accurate.

on U.S. Business

risk of a massive corporate flight. Asked whether the measures under consideration might make Canada a less attractive country in which to invest, Gray retorted, with heavy sarcasm: "Compared to what? Iran?"

The American business community hasn't yet reacted to the latest wave of Canadian nationalism, apparently preferring to reserve judgment until the anti-foreign provisions of the new energy program actually are extended to other industries. According to Alexander C. Tomlinson, chairman of First Boston Corp.'s executive committee, "People are waiting for the other shoe to drop." Some don't think it ever will drop. Says Lawrence A. Fox, vice president for international economic affairs of the National Association of Manufacturers: "You may find some people with taut nerves about this. But I'm inclined to scoff a bit. There is nationalist talk in Canada all the time, but U.S. companies will stay there. They can't come home—they're there." Besides, Fox observes, Canadians can't afford to buy out all those companies.

This sanguine view is shared by David L. McInnes, Canadian-born president of Weyerhaeuser Canada. "You have to respond to the actualities," McInnes comments. "We Canadians are great savers but we are not a rich country and you can't wave a wand to raise capital. So for pragmatic reasons I think risks to the industrial sector are minimal."

The bad news for $1,800

But there is also a growing sense that the environment for American business in Canada could be a lot less agreeable in the future. In January a New York-based research and consulting firm, Multinational Strategies Inc., published a 156-page report on the long-term business environment in Canada. Within two weeks, 20 companies, including IBM, Dow Chemical, and Alcoa, plunked down $1,800 each for copies of the report. It noted Canada's need for foreign investment, yet anticipated increased pressure on foreign companies.

Said the report: "Complexity and uncertainty will increase ... because of the determination of Canadians to control a larger share of their national economy. For the first time in key economic sectors, there is now a real Canadian alternative to foreign control. We feel that foreign companies can expect to see a much closer alliance between governments in Canada (at both the federal and provincial level) and local entrepreneurs, in an effort to expand Canadian control." The report added that foreign companies could look forward to "a more interventionist business environment," and that the government could be expected "to enlarge the area of uncertainty ... by forcing firms to bargain for desired benefits or permissions."

Stephen Blank, one of the report's authors, points out that the business climate in Canada could be a bit dicey in coming years even without a new wave of nationalism. In Blank's view, the current domestic struggles between Ottawa and the provinces over such issues as the constitution and control of natural resources would themselves be sufficient to make things tough for foreign-owned

companies. The new nationalism will make a difficult situation worse.

Canadian nationalism is rooted in the fact that the country has for decades been heavily influenced by foreign, mostly U.S., companies. Roughly a century ago, when Ottawa built a tariff wall to protect its fledgling industries, U.S. companies began to set up branch plants in Canada to serve the local market. Before long, many of these subsidiaries had joined the ranks of Canada's largest companies. The tariff wall has largely crumbled now, but the old pattern has remained. In no major industrialized country do foreign-owned companies play so large a role. Today, in addition to their majority ownership of the oil industry, U.S. companies own 32% of the pulp and paper industry, 36% of the mining and smelting industry, 39% of manufacturing as a whole. Of the 100 largest companies in Canada, 37 are U.S. owned or controlled. The foreign-ownership data are even more striking when such non-U.S. companies as Royal Dutch/Shell and Unilever are included.

Daniel Wiener

Pierre Trudeau sometimes says he's not an economic nationalist, but he chose Herb Gray (left), a nationalist hero, as industry minister.

It's the foreigners' fault

Back in 1971 Herb Gray, then one of Trudeau's junior ministers, wrote a paper that was to become gospel for the budding economic-nationalist movement. The Gray Report, as this document came to be known, attributed Canada's economic plight largely to the extensive foreign ownership of its industries. Canada had a "branch-plant economy," Gray maintained, whose characteristics included stunted technological development and low levels of R&D. Gray argued that foreign-owned companies simply did not provide their host countries with benefits equal to those provided by indigenous companies. Solution: increased Canadian control of the country's economic assets.

Trudeau himself was always sympathetic to such arguments. In 1971 he created the Canada Development Corporation. In 1974 he created the Foreign Investment Review Agency, which began screening applications by foreign investors to purchase Canadian companies; in a few celebrated cases, FIRA forced U.S. companies with Canadian subsidiaries to sell them to Canadian investors. And Trudeau announced his "Third Option"—a foreign policy designed explicitly to loosen U.S.-Canadian ties.

Then, in 1980, Trudeau used the appeal of economic nationalism in his successful campaign to oust Prime Minister Joe Clark (who had been in office only six months). On February 12, 1980, Trudeau delivered an extraordinary speech to the Toronto Advertising and Sales Club in which he spelled out his views on foreign investment. Unlike many campaign speeches, this one offered startling and specific details. Said the once and future Prime Minister: "In a mature economy like Canada's there are opportunities to repatriate foreign ownership of Canadian assets. Within this framework, the Foreign Investment Review Agency can have an important role to play. We want to expand and strengthen FIRA, not weaken it. FIRA's mandate will be broadened to include the periodic review of all foreign firms of large size to assess the performance of these companies in such areas as export promotion and research and development. Most importantly through government guarantees of bank loans, FIRA will help provide financial assistance to Canadian companies that want to compete for foreign takeovers or repatriate foreign ownership of assets."

Any doubts that Trudeau meant what he said were laid to rest after his big victory, when he named Herb Gray to the crucial post of industry minister. The P.M. could scarcely have sent a stronger signal. Gray says that his mandate is to turn Trudeau's Toronto speech into policy and that specific measures will be announced as the cabinet approves them, a process that will stretch out over the next two years or so.

The recent sequence of events in the oil industry suggests a pattern the government might be following elsewhere. First, Ottawa swung a sledgehammer by announcing an energy policy harsher than anyone had anticipated. Among its provisions: Ottawa gets an automatic 25% share of any oil or gas found on federal property—which is where most new strikes are likely to be made; and new leases to explore on federal land will be given only to companies that are at least 50% Canadian owned. Result: a sharp plunge in the stock prices of foreign-owned oil companies traded in Canada.

Having knocked down the value of foreign-owned oil companies and effectively crushed whatever exploration plans they might have had, Ottawa launched Petro-Can on a buying spree. Petro-Can was the country's 12th-largest oil company be-

Petro-Can may soon be the No. 1 oil company.

fore its Petrofina takeover; now it's No. 5. And Petro-Can may soon be No. 1: Canada's energy minister, Marc Lalonde, said even before the Petrofina takeover that within a year Petro-Can would buy one to three foreign-owned oil companies.

Ottawa has also moved to give Canadian companies a big share of the offshore drilling-rig market. One provision of the new Canada Oil and Gas Act now before Parliament requires foreign-owned companies seeking exploration licenses to submit plans to the government that, among other things, spell out how the company intends to make "maximum use" of Canadian goods, services, and labor. Andrew A. McArthur, president of Saint John Shipbuilding & Drydock Co. in New Brunswick, says his company may be among those moving to take advantage of Ottawa's new approach by starting to build rigs. As McArthur explains it: "We have strong indications that oil companies are being told that the higher the Canadian content of their proposals, the more kindly they will be treated in Ottawa."

Muscling in on IBM

The office-equipment industry has long had the sense that it is on Trudeau's hit list. Ottawa has already made clear that it considers the development of a domestic office-equipment industry crucial to the country's future. Last year Ottawa announced plans to issue $55 million in research grants to some of the young Canadian firms—for instance, Mitel Corp., an Ottawa-based producer of telephone switching devices—that have managed to establish footholds in this fast-moving industry. According to Gray, the government will now use its powers of procurement to encourage all public agencies—which account for about 25% of the country's $2.2-billion market—to buy Canadian equipment, or whatever alternative equipment includes the highest percentage of Canadian-produced components. It is not yet clear how these measures will affect IBM, Xerox, and other U.S. companies with Canadian subsidiaries.

So far, the only organized American op-

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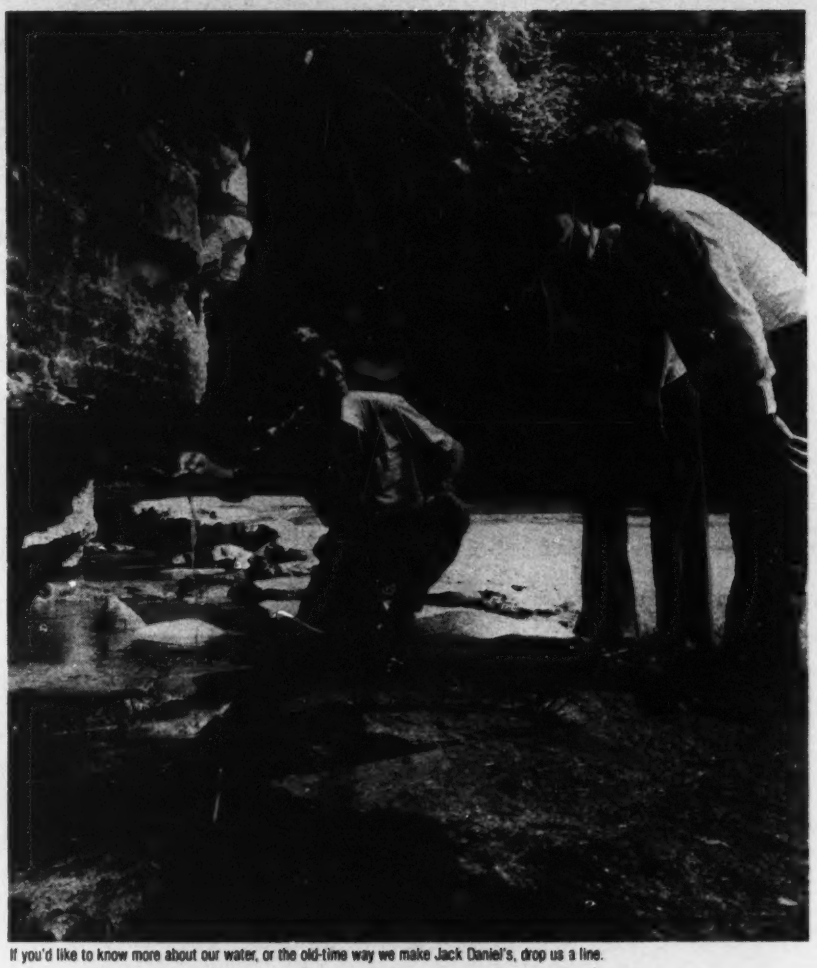

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"We rate ourselves good on 13 of the 14 guidelines."

position to Canada's new nationalism has come from Washington. U.S. trade and diplomatic officials are loudly protesting the procurement provisions of the pending oil and gas legislation—even threatening to charge Canada formally with violating the "national-treatment" provisions of the General Agreement on Tariffs and Trade (GATT).

Touting the local content

Up in Canada, meanwhile, many executives of U.S.-owned companies have been working to build the case that they've been good Canadian citizens. Peter M. Brophey, vice president of Xerox Canada, says that he's been carefully monitoring his company's compliance with the Gillespie Guidelines. Reports a happy Brophey: "We rate ourselves as good—on a scale of good, fair, and poor—on 13 of the 14 guidelines." (The one low rating relates to the rule urging foreign-owned companies to make shares available to Canadian investors; like a lot of foreign-owned companies, Xerox Canada is a wholly owned subsidiary.) Like other U.S.-owned companies in Canada, Xerox has tried to win public favor by touting the high local content of its products.

Lorne K. Lodge, chairman and president of IBM Canada, reports with satisfaction that his company relies on more than 7,000 Canadian companies to supply materials. Lodge, a Canadian citizen, adds that the company has been especially careful to hire and promote Canadians. But because of the way IBM Corp. is structured, he adds, his unit has no world mandates. James M. Hay, chief executive of Dow Chemical of Canada, contends that his company didn't have a problem with the guidelines when they came out in 1975 and doesn't have a problem with them now. Whether Herb Gray and his people agree remains, of course, to be seen.

Some U.S. companies could doubtless challenge the basic idea behind Canada's economic nationalism—the idea that foreign-owned companies have done little to promote advanced technology in Canada. In fact, Pratt & Whitney's Canadian

continued

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The departure of Herb Gray might slow the drive.

unit is that company's sole worldwide supplier of jet engines for small planes. General Electric's Canadian unit is that company's sole producer of certain types of paper-making machinery and hydraulic turbines. Xerox products sold around the world include document-input devices made exclusively by the company's Canadian unit.

Where to find researchers

The recent performance of foreign-owned companies is even more striking in the all-important field of R&D. According to Statistics Canada, Ottawa's official numbers compiler, foreign-owned companies accounted for a remarkable 44% of all industrial research and development done in Canada in 1979 (the latest year for which figures are available). Since quite a few U.S.-owned companies are in autos, rubber products, and other industries that have low R&D expenditures, it follows that many other U.S.-owned companies are more than pulling their weight. In any case, companies these days tend to build their R&D facilities not so much where they want to build them as where R&D people are available in quantity. This explains why even Northern Telecom, the telecommunications-equipment giant that is one of Canada's indigenous world-class companies, has more than 500 of its roughly 2,000 R&D people based in the U.S., mostly in California.

Just how far the current nationalist drive will go is open to question. In general, nationalist sentiment in Canada is strongest during times of prosperity; when things turn really sour, Canadians become less interested in foreign-ownership issues and more interested in the unemployment rate. Moreover, Ottawa's current emphasis on forcibly reducing foreign ownership could weaken if Trudeau steps down in a year or two, as he has hinted he might. The departure of Herb Gray for any reason might also slow down the nationalist drive. Meanwhile, U.S. businessmen north of the border should brace themselves for a colder investment climate. F